IT 02-0041-GIL 09/27/2002 PUBLIC LAW 86-272/NEXUS

General Information Letter: Drop shipment of goods from Illinois to another state will not create nexus for seller with no other contacts with Illinois.

September 27, 2002

Dear:

This is in response to your email dated September 25, 2002, in which you request a letter ruling. The nature of your request and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. *See* 86 Ill. Adm. Code 1200.120(b) and (c), which may be found on the Department's web site at www.revenue.state.il.us.

In your email you have stated the following:

> We are requesting that the Department issue a general information letter with respect to the issues addressed below. To the best of my knowledge, the Department has not previously ruled on the same or a similar issue for the taxpayer or a predecessor, nor have we submitted the same or a similar issue to the Department which was withdrawn before a letter ruling was issued.

Facts

Company A is a foreign-owned pharmaceutical company headquartered in New York City and doing business in 13 states. A has its only U.S. warehouse and distribution center in IL. A purchases products from its foreign parent or from third parties, packages the products in another state (or contracts with third parties to package products), and then sends the products to its IL warehouse, from which it ships to its customers' locations via third party carrier throughout the U.S. For IL income tax purposes, A currently does not throw back its sales to customers located in the 13 states in which it has nexus beyond P.L. 86-272 and files returns, but does source or throw back to IL its sales to IL customers and to customers in the other states in which it does not have nexus.

A will purchase a controlling interest in B, a partnership which runs a pharmaceutical business with its main office in NYC, at which location B accepts all orders from its customers. After the purchase, A will directly own a 4.9% general partnership interest in B, and will indirectly own the remaining 95.1% general partnership interest in B. After the purchase, A and B will sell products manufactured by A's parent or by third parties. After A's purchase of B, however, only A--not B--will solicit or sell products for delivery to Illinois destinations.

At the time of purchase, B will enter into a contract with A, under which A's salesmen will solicit, market, and sell on behalf of B. B will fill every customer order by placing an order with A. A will fill the B order by shipping the product from A's IL warehouse to B for delivery at the location of B's customer. A will pass title to B at the B customer location, and B will simultaneously pass title to the customer at such location. Unlike the situation in other states, however, B will not solicit or sell products for delivery to

Illinois destinations. Moreover, A will not solicit or sell products on B's behalf in Illinois nor conduct any other activities on behalf of B in Illinois. Other than the foregoing connections, B will have no nexus with Illinois.

For purposes of this request, assume that A and B will be members of a unitary business group ("UBG") following A's purchase of B and that A will file a combined return in IL that includes B.

Rulings requested

We seek rulings that:

1. A's sales to B are properly eliminated from the UBG's IL sales factor.

2. B's sales are properly included in the denominator of the UBG's IL sales factor, but not in the numerator.

Analysis and Conclusions [of the Taxpayer]

1. A's sales to B are sales between members of the UBG and are therefore eliminated for IL purposes. See 86 Ill. Adm. Code 100.5270(a).

2. Under regulation 86 Ill. Adm. Code 100.3380(c)(1), a seller's sales are thrown back to Illinois and included in the seller's Illinois sales factor numerator only if the seller has nexus in IL that goes beyond the activities protected by Public Law 86-272. While the regulation covers the so-called "double throwback" situation, and does not specifically deal with the throwback of sales whose shipment originates in IL, it is difficult to see why the same "nexus" threshold for taxation and throwback would not apply.

We have found no court decisions addressing whether nexus is a precondition to application of the throwback rule. The two authorities we have located, however, suggest that tax nexus is a prerequisite to throwback:

> In Letter Ruling No. 90-200 (8/2/90), an out-of-state direct mail marketer, without property or employees in Illinois, entered into a drop shipment agreement with an IL manufacturer to ship the goods directly from the manufacturer's IL location to ultimate purchasers located throughout the U.S. Aside from the drop shipment arrangement, the direct marketer had no connection with Illinois. The Department ruled that the drop shipment arrangement would not by itself subject the direct marketer to tax and that the direct marketer's related sales would not be sourced or "thrown back" to IL.
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> In Administrative Hearings Decision IT 97-7, the Department addressed a taxpayer's argument that the statute's use of the word "person" in relation to the

> throwback rule must be read to refer to the entire unitary business group where, as in that case, the taxpayer had elected under Sec. 502(e) to be treated as one taxpayer. The Department found this interpretation inconsistent with the combined method of apportionment. According to the Department's administrative law judge, "Even though taxpayers combine their taxable incomes and 'everywhere' factors, the numerator of the apportionment factors must be looked at on an individual company by company basis. Only corporations which have nexus in Illinois can have Illinois sales included in the numerator." (emphasis supplied).

On the facts present in this ruling request, B is not subject to taxation by IL, and its sales may not be thrown back to IL, since B has no nexus in the state. B has no property, payroll, sales or customers in IL, and therefore has no nexus in IL as a result of its own activities. B also has no nexus in IL as a result of its contract with A for the provision of solicitation services, since A will not perform such services on behalf of B in IL. Nor does B acquire nexus as a result of the fact that the goods sold by B to customers in other states will be stored in IL prior to the sale, since A (not B) will lease the IL warehouse, will own the inventory and will store the inventory on its own behalf. In other words, B will have no business activity in IL sufficient to create statutory or constitutional nexus.

Accordingly, B's sales are properly included in the denominator, but not in the numerator, of the UBG's IL combined return sales factor.

Response

Sales Factor Sourcing of Drop Shipment Sales

86 Ill. Admin. Code Section 100.3380(c)(1) provides:

> In the case of sales where neither the origin nor the destination of the sale is within this State, and the person is taxable in neither the state of origin nor the state of destination, the sale will be attributed to this State (and included in the numerator of the sales factor) if the person's activities in this State in connection with the sales are not protected by the provisions of P.L. 86-272, 15 USC 381-385.

The term "state of origin" refers to the provision in the throwback rule in Section 304(c)(1)(B)(ii) of the Illinois Income Tax Act (35 ILCS 5/101 *et seq.*), which allocates gross proceeds from a sale of tangible personal property to the Illinois sales factor numerator if the seller is not subject to tax in the destination state and "the property is shipped from an office, store, warehouse, factory or other place of storage in this State"; i.e., if Illinois is the state of origin.

This provision can have application only if it is possible for a seller to have no nexus with a state despite the fact that property being sold by the seller is shipped from a place of storage within that state. Accordingly, this provision is based on the assumption that mere shipment of goods from a

state on behalf of a person selling those goods will not, of itself, cause that person to have nexus with the state.

There are no Illinois authorities on point, and no authorities in other states that deal with the precise nexus issue under facts similar to those you have represented in the ruling request. However, in *Langley v. Administrative Hearing Commission,* 649 S.W.2d 216 (1983), the Missouri Supreme Court held that a drop shipment was, in fact, two distinct and independent transactions: a purchase of the goods and a resale of the goods by the same party. Based on this reasoning, the court held that sales by a Missouri-based retailer of goods that were drop-shipped from outside Missouri to a Missouri purchaser were transactions occurring entirely within the State of Missouri. For sales factor purposes, the gross receipts from such transactions were therefore allocated entirely to Missouri rather than allocated only fifty percent to Missouri, which would be the proper treatment for a transaction occurring partly within and partly without Missouri. In effect, the court held that the drop shipment from outside Missouri did not establish nexus between the seller and the state of origin with respect to that particular transaction.

Based on that holding, a taxpayer whose only connection with the State of Illinois is through drop shipments of goods from Illinois to purchasers outside the State would not have nexus with the State of Illinois.

Note that this letter does not rule that Company B has no nexus with Illinois, only that no nexus is created by the drop shipment transactions described in your request.

Elimination of Intercompany Sales

86 Ill. Admin. Code Section 100.3320(d) provides:

> Elimination of income and deduction items arising from transactions between members of the group must be done whenever necessary to avoid distortion of the group's income, the denominators used by all members of the group in calculating apportionment factors, or the numerators used by any particular member of the group in calculating its apportionment factors.

Failure to eliminate from the sales factor a transfer between members of a unitary business group would alter the sales factor of the group. In contrast, a transfer between divisions of a single taxpayer would never affect the sales factor of that taxpayer. Section 502(e) of the Illinois Income Tax Act requires corporate members of a unitary business group to "be treated as one taxpayer." Accordingly, failure to eliminate intercompany sales from the sales factor would cause the amount of business income apportioned to Illinois by a unitary business group to be different from the amount that would be apportioned by a single taxpayer in otherwise identical circumstances. Sales from Company A to Company B must therefore be eliminated from the numerator and denominator of the sales factor.

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual

situation, please submit all of the information set out in items 1 through 8 of Section 1200.110(b). If you have any further questions, you may contact me at (217) 782-7055.

Sincerely,

Paul S. Caselton
Deputy General Counsel -- Income Tax